



THE UNIVERSITY *of* EDINBURGH

Edinburgh Research Explorer

The Bankers' New Clothes – What's Wrong with Banking and What to Do about It

Citation for published version:

Moreira, F 2015, 'The Bankers' New Clothes – What's Wrong with Banking and What to Do about It', *Journal of Financial Innovation*, vol. 1, no. 3, pp. 268-271. https://doi.org/10.15194/jofi_2015.v1.i3.41

Digital Object Identifier (DOI):

[10.15194/jofi_2015.v1.i3.41](https://doi.org/10.15194/jofi_2015.v1.i3.41)

Link:

[Link to publication record in Edinburgh Research Explorer](#)

Document Version:

Publisher's PDF, also known as Version of record

Published In:

Journal of Financial Innovation

General rights

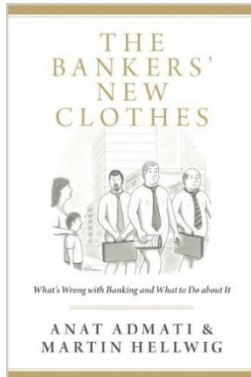
Copyright for the publications made accessible via the Edinburgh Research Explorer is retained by the author(s) and / or other copyright owners and it is a condition of accessing these publications that users recognise and abide by the legal requirements associated with these rights.

Take down policy

The University of Edinburgh has made every reasonable effort to ensure that Edinburgh Research Explorer content complies with UK legislation. If you believe that the public display of this file breaches copyright please contact openaccess@ed.ac.uk providing details, and we will remove access to the work immediately and investigate your claim.



BOOK REVIEW



THE BANKERS' NEW CLOTHES – What's Wrong with Banking and What to Do about It

Anat Admati and Martin Hellwig

Princeton and Oxford: Princeton University Press, 2013, 398p.

Review by

Fernando Moreira

Lecturer (Assistant Professor) in Business Economics, University of Edinburgh Business School

Fernando.Moreira@ed.ac.uk

Sometimes inaccurate arguments are repeated so often and with impressive (apparent) authority that most people take them for granted. Anat Admati and Martin Hellwig illustrate one of these situations in their book *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*. By using a pun inspired by the classic tale *The Emperor's New Clothes* by Hans Andersen, Admati and Hellwig guide us around the world of the “bankers’ new clothes”, that is, “flawed and misleading claims that are made in discussions about banking regulation” (p. 9). In the tale, everybody initially pretends to see the emperor’s invisible clothes in order not to appear stupid given that the invisible clothes were made by two (allegedly) highly skilled weavers.

The greatest merit of this book is its explanation, in very accessible language, of fallacies concerning the capital that banks should have in order to avoid bankruptcy. One does not need to have a university degree to understand the authors’ arguments. One just needs to keep an open mind and to realise that not everything that is said by bankers, academics and politicians is necessarily true. I worked at a Central Bank for a number of years and I have been teaching and

doing research on banking regulation at other times but I confess that I never assumed that this issue could be explained in such simple terms as Admati and Hellwig have admirably done in their book.

In very simple terms, banks can fund their investments (assets) in two ways: debt (e.g. deposits and bonds) and equity (typically called *capital* in banking jargon). I wonder how often academics have discussed this issue (bank capital) without the necessary care. They just replicate the terminology used in the banking regulation and pass on the idea that capital should remain frozen and cannot be invested. A source of confusion in this regard is that capital has been mistaken for liquidity reserve (i.e. the ratio of deposits that should commonly be held as deposits at Central Banks and/or cash). Capital is just another source of funding for investments like debt.

The authors point out that banks have the incentive to prefer debt over equity because the former is cheaper than the latter. This is the case because part of the cost of debt is borne by the government (i.e. taxpayers) given that there is an implicit belief that banks will be rescued if they face any difficulty. In other words, the interest rate paid on debt by banks is relatively low because creditors (depositors, in particular) feel safe due to the possibility of bailouts and therefore do not demand higher interest rates.

The way bank managers' compensations are typically calculated also plays a role in maintaining low levels of equity. One of the performance measures used by financial institutions is the Return on Equity (ROE), which, as the name implies, is calculated as return (however it is measured) divided by the level of equity. Thus, assuming everything else to be constant, the more equity a bank has, the lower its ROE and, therefore, the lower its managers' compensation will be.

Another reason in favour of debt over equity from the banks' viewpoint, is the preferential tax treatment of debt when compared to the treatment given to equity in most countries. The interest paid on debt is tax deductible expenses while the payment of dividends on equity does not have the same benefit.

As banks have the incentive to have as little equity as possible and since the cost of potential failures is subsidised by taxpayers, bank managers may act in a careless way, which contributes to the increase in the fragility of the financial system. The solution presented by Admati and Hellwig in order to overcome this problem is to require banks to increase the ratio

equity/debt. In other words, banks should be required to have more capital than they have nowadays.

Yet, despite all the clear and convincing arguments, two relevant points are left unexplained by the authors. In another review of this book, Myerson (2014) focuses on the importance of information and agents' incentives to the stability of financial systems. In this review, I concentrate on a couple of particular aspects that could have been further developed by Admati and Hellwig.

First, as a general recommendation, the authors say that bank capital (equity) should be between 20% and 30% of total assets rather than the current ratio (3%) or the alternative ratio defined as 7% of the so-called *risk weighted assets*. It is argued that the percentage of bank capital with respect to assets in the 19th and at the beginning of the 20th century was, on average, 25% and financial institutions were able, therefore, to absorb more losses with their own capital before affecting their creditors (e.g. depositors).

The ratio suggested by the authors is intuitively better than the ratios stipulated in any of the three Basel Accords because the former is higher and bank creditors would be safer (i.e. a higher level of equity would absorb more losses before they impact on the investments of creditors). However, apart from this intuitive explanation and from the average of equity held by banks in the past, the figure proposed by Admati and Hellwig (between 20% and 30%) sounds as random as the values stated in Basel.

The fact that banks seemed safer in the past two centuries, when their equity represented on average 25% of their assets, does not imply that in the future this ratio will be sufficient to cover unexpected losses incurred in bank portfolios. In the future, stressful periods may be worse than observed in the past and this would compromise the success of capital regulation given that its objective is to ensure that financial institutions are prepared for unexpected (extreme) losses with a given confidence. So, the solution is to invest in the search for statistical and mathematical models that are more realistic than those currently adopted in the regulation; models that will allow us to better anticipate the magnitude of bank losses. Simply guessing ratios of capital will not do the job since such guesswork will result in banks remaining considerably exposed to adverse events in the future.

The second issue that deserves a more careful analysis refers to the "labels" given to the stakeholders mentioned in the arguments presented by Admati and Hellwig. The designations

used (taxpayers, depositors/creditors and shareholders) are static and do not represent the complex reality we live in. For instance, how can we classify in this context those who simultaneously pay taxes (taxpayers), have current or saving accounts (depositors/creditors) and have shares in financial institutions (shareholders, in particular the minor ones)? To a certain extent, such individuals would subsidise themselves! Naturally, the level of subsidy would depend on what ratio of their wealth is associated with each of those transactions. I assume that when the authors mention “shareholders” in the book, they have extremely well-off capitalists in mind.

If the suggestions made by Admati and Hellwig are implemented, i.e. if the ratio of capital is raised, who will be the additional owners (shareholders) of banks? Will some existing creditors (e.g. depositors or bondholders) become shareholders? And, if this were the case, what would be the impact on the economy if those “new” owners lost their investments? We should remember that we cannot restrict the banking industry to just two types of investor: a wealthy type who invest in stocks (“owners”) and the rest of us (let us say “taxpayers”) who are creditors expecting to receive interest rates from investments in banks alone. Those two classes are mixed and any of us can move freely between them. For example, taxpayers can also be owners (shareholders) of banks.

Banning dividends to shareholders until banks reach what is considered to be an adequate level of equity would help raise the ratio of capital. Nonetheless, it is not clear if that would be enough; neither is it clear how long it would take especially because the expectation of no future payouts would make shares less attractive and cause their prices to fall (which, in turn, would reduce the value of bank capital). Therefore, more bank owners will be needed in order to satisfy the authors’ solution. If a significant number of these new shareholders are current taxpayers, the future losses in the banking system will be basically borne by the same people (i.e. the taxpayers of today who will be the shareholders of tomorrow). Certainly, the decision to become shareholders depends on the risk appetite of prospective investors and on their understanding of the potential consequences. The proportion of the taxpaying population who would be willing, as shareholders, to continue to bear the risk faced by banks is something we will learn in the future if banking regulation moves towards the recommendations made by Admati and Hellwig.

In the meantime, we, as a society, need to realise that the existence of banks is only justifiable if they can serve us by promoting the flow of resources in order to keep our economy

working smoothly. Think of hospitals for instance. What if they started aiming at multiplying their assets by speculating with their resources in the financial markets (or in any other way) and saw their patients as just “one aspect of their business”?

In Andersen’s tale, *The Emperor’s New Clothes*, a little child dared to warn everybody else about the fact that the emperor had no clothes. The invisibility was a nonsensical argument stated with such impressive confidence by the two weavers who made everybody (except the aforementioned child) afraid of contradicting them. In our (real) world, we need many more people who dare to challenge the pompous nonsensical arguments of some experts in banking regulation.

Additional reference

Myerson, Roger B. (2014). Rethinking the Principles of Bank Regulation: A Review of Admati and Hellwig’s *The Bankers’ New Clothes*. *Journal of Economic Literature*, 52(1), pp. 197-210.